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SUBJECT: FRANCHISING IN MEXICO PART II: PRESENT AND FUTURE
TRENDS

REF: MEXICO 2595

Sensitive but unclassified, entire text.

This is the second in a series of two cables reviewing the franchise sector in Mexico.

¶1. (SBU) Summary. Being driven by domestic and foreign investment, the franchise industry grew by 17 percent in ¶2005. While U.S. companies presently comprise most of the foreign-based franchises in Mexico, a substantial increase in the presence of Central and South American, European, and Chinese investment is likely in the immediate future. No longer confined to restaurants, Mexican franchises continue to grow and diversify, offering new products and services as well as building wealth and employment at home. End Summary.

NOT JUST MCDONALDS

¶2. (SBU) Previously consisting largely of fast-food restaurants, the franchise sector in Mexico has experienced a strong and increasingly diverse resurgence since the recovery of the peso following the 1995 crisis. Franchising expansion has been coupled with a corresponding explosion of creative concepts, encountering mixed success. However, as the sector has matured, the five-year success rate for new concepts has risen from 55 percent in 1999 to over 80 percent today, according to data from the Mexican Franchise Association (MFA). Services are the largest and fastest growing industry segment, making up approximately a quarter of all franchises in Mexico, closely followed by food and beverage chains. The percentage of franchises classified as "other" with unique business models such as mobile compact disk stores, while-you-wait clothing repair, or business expense reducting consulting has risen to 35 percent, and represent a significant part of the sector's innovation and growth.

THE NEW MEXICAN CONSUMER

¶3. (SBU) A key factor underlying the proliferation of franchise concepts has been the changing degree of social acceptance and reliance upon franchised services and products. According to the National Institute of Statistics (INEGI), over 4 million Mexican homemakers have entered the workforce since 1995, increasing demand for take-out/delivery restaurants, childcare and educational services. In addition, greater cross-border communication with the U.S. has led to familiarity and acceptance of American names,

advertising and decorative styles, and products. Similar to an earlier phenomenon in the U.S., the growth of Mexican suburbs and office parks has encouraged dining out.

MORE EFFECTIVE TROPICALIZATION

14. (SBU) Adapting a product to Mexican sensibilities and preferences is often known as "tropicalization". During the first franchise boom, a number of successful U.S.-based franchises struggled to build a customer base. Steven Pepper, Director General of "Yum! Restaurants International", the KFC and Pizza Hut master franchisor in Mexico, related his experiences to Econoff. Pepper stressed that tropicalization is often a nuanced process necessary for survival. Pepper cited the example of the Ms. Fields Cookies franchise, a company ultimately forced to close their Mexican franchises in the 1990s, partly due to a lack of adaptation. They only offered cookies, a strange product in a country where desserts are primarily bread-based - and the name "Ms. Fields" did not bring sentimental images to the minds of most Mexicans. Even American-style franchises have tropicalized; Yucatan coffee is a staple of Starbucks' menu, and Subway sells a vegetarian avocado sandwich.

SUPERIOR SUPPLY CHAIN

15. (SBU) Increased reliance upon Mexican suppliers has also increased the competitiveness of American franchises. Jorge Yitani, owner of the Subway master franchise for the states of Puebla and Tlaxcala, told Econoff that the proportion of supplies imported from the U.S. has fallen from 90 to 35 percent over 10 years. KFC experienced a similar phenomenon,

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with its percentage of U.S.-sourced supplies dropping from 95 to 40 percent. Reasons for this change include a more stable Mexican currency, improved supplier reliability, and enhanced product quality. With cheaper, more reliable supplies, franchises are now more competitive versus their local rivals. For example, Pepper explained to Econoff that in 1995, the meal price at KFC was 80 percent more than a meal purchased from a street vendor, but today it is only 15 percent more expensive.

FOOD AND BEVERAGES

16. (SBU) Food and beverage chains continue to grow and diversify in Mexico. According to Pepper, KFC already has 11,000 employees and 400 million dollars in yearly revenue, and plans to add 20 additional stores this year (to 300 existing branches), creating approximately 600 new jobs. Alberto Torrado of Alsea, the master franchisor of Dominos, Popeyes, Burger King, and a joint-venture partner with Starbucks, expects his company to grow by 15 percent in 2006. This expansion is not limited to large established chains. Marco Empoli, the franchisor of Empoli Pizza, a Mexican chain founded in 2001, has grown from 3 to 21 franchises in two years, and hopes to add another 19-20 restaurants over the next several years. Smaller U.S. franchises are also joining the fray - Pepper pointed out that Pizza Hut is now facing strong competition from new players such as Via Pizza, who entered the Mexican market in 2004. Taking advantage of the trend toward healthy food consumption, there are new franchises such as Salad Creations and Delit, a Mexican chain offering frozen yogurt and fruit.

SERVICES

17. (SBU) According to Ramos, services are included among 3 out of Mexico's 5 fastest growing franchise concepts. Franchises proffering childcare, eldercare, tutoring, and arcades now fill today's more urgent needs. Another example

is "Two Men and a Truck", a U.S.-based franchise entering the Mexican market this year, reflecting a changing social dynamic. The quest to discover underserved consumer demand has led to innovation - the Spanish franchise Naturhouse offers on-site dietetic counseling and a range of health-food products.

YOUR WORLD OF THREE PESOS

18. (SBU) Included in the "other" franchise segment, "El Mundo de a 3 Pesos" (Your World of 3 Pesos) has been the fastest growing franchise in Mexico for two consecutive years. Co-owner Daniel Sutton told Econoff that since its opening in 2003, El Mundo has added 300 stores, and they plan to have 1,500 branches throughout Mexico by 2011. El Mundo's strategy is simple - capitalize on the demand for cheap products by offering a range of items, such as kitchen utensils, cups, and deodorants, for three pesos. Investment in an El Mundo franchise is accessible for the middle-class, requiring an initial investment of 20,000 pesos and a monthly fee of 10,000 pesos. During a tour of their manufacturing plant 25 miles north of Mexico City, Sutton explained that initially El Mundo imported all of its products from China. Today 60 percent is manufactured in Mexico, thereby creating a new profit center, increasing efficiency of distribution, and creating 600 new direct-hire jobs. El Mundo's success has provided a model for several new imitations, including "La Tiendita de 3 Pesos" (The little store of 3 pesos), and stimulates investment and job creation.

FONART

19. (SBU) Inaugurated in 1974 as a department of the Ministry of Social Development (SEDESOL), the National Fund for the Support of Artisans (FONART) offers franchising licenses to sell authentic Mexican handicrafts at home and abroad. Currently, there are 9 FONART branches in Mexico, 5 in the U.S., and 2 in Europe. Alejandra Lopez, Director of the Department of Franchises, told Econoff that applications for new franchises are booming, and they expect another five branches will be opened this year (the average investment is 100,000 US dollars). While due to its relatively small size,

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FONART will probably not make a significant impact on the Mexican retail sector, the program provides a market for rural artisans and offers an interesting example of public-private sector collaboration for the promotion of economic development.

NON-US FOREIGN INVESTMENT INCREASING

110. (SBU) While European, Latin American, and Chinese franchises account for only 5 percent of all franchises in Mexico, the recruitment of franchises from these regions is a high priority for the MFA, according to Ramos. Taking advantage of the underdeveloped marketplace, companies such as Creppaletas (Brazilian restaurant), Broncearium (Spanish tanning salon), and Autowash (Italian automatic carwash) have recently entered the Mexican franchise sector. Some of these are already offering significant competition - Pollo Campero, a Guatemalan franchise, was counted by Pepper as one of KFC's fiercest competitors. This trend should continue in the future, as foreign franchises continue to develop stronger distribution chains and brand name recognition.

COMMENT

111. (SBU) The near future looks promising for Mexican franchising, and will likely provide a significant revenue and job-creation boost to the overall economy. More varied than ever before, franchising continues to meet the changing

needs of a changing society, with further diversification of services and products likely. Although franchising in Mexico will continue to be a prime opportunity for American investors, it is no longer an "easy" market to penetrate, but rather an extremely competitive sector in which U.S. chains will have to utilize tropicalization, economies of scale, and maximize supply and distribution efficiency.

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